

# ANALYSIS OF ORIGINAL BILL

## Franchise Tax Board

Author: Rod Pacheco Analyst: Darrine Distefano Bill Number: AB 1151  
Related Bills: See Legislative History Telephone: 845-6458 Introduced Date: 02-23-2001  
Attorney: Patrick Kusiak Sponsor: \_\_\_\_\_

**SUBJECT:** Education IRAs/Increases Contributions Allowed & Distribution May Be Used For Elementary & Secondary Education

### SUMMARY

This bill would do the following:

- Increase the amounts that can be contributed to an Education Individual Retirement Account (IRA) over the next five years.
- Allow taxpayers to contribute to an Education IRA for elementary and secondary education costs.

### PURPOSE OF THE BILL

The author's staff has indicated that the purpose of this bill is to provide incentives for taxpayers to save more for all educational expenses.

### EFFECTIVE/OPERATIVE DATE

This bill is a tax levy that would be effective immediately upon enactment and operative for taxable years beginning on or after January 1, 2001.

### POSITION

Pending.

### ANALYSIS

#### FEDERAL/STATE LAW

Federal law allows taxpayers to establish an IRA for educational savings. Taxpayers with modified adjusted gross income (AGI) below \$150,000 (\$95,000 for single taxpayers) may contribute up to \$500 annually per beneficiary to an Education IRA. The \$500 contribution limit is phased out for high-income taxpayers. However, these taxpayers may contribute a minimum of \$200.

Contributions to an Education IRA are not deductible and investment earnings are not taxed as earned, but are only potentially taxed when withdrawn. If beneficiaries use the earnings for "qualified higher education expenses," the earnings are tax free when withdrawn. However, a 10% penalty is imposed if the earnings are used for other purposes. A 6% penalty applies to excess contributions. The limitation applies to each contributor; therefore, an individual may be the beneficiary of several different Education IRAs.

Board Position:

<input type="checkbox"/> S	<input type="checkbox"/> NA	<input type="checkbox"/> NP
<input type="checkbox"/> SA	<input type="checkbox"/> O	<input type="checkbox"/> NAR
<input type="checkbox"/> N	<input type="checkbox"/> OUA	<input checked="" type="checkbox"/> PENDING

Department Director

Date

**G. Alan Hunter for GHG 04/19/01**

Qualified higher education expenses include tuition, books, supplies, and equipment required for enrollment or attendance at an eligible educational institution. Qualified higher education expenses include, with certain limitations, room and board. An eligible educational institution is generally an accredited, post-secondary educational institution that is eligible to participate in the Department of Education student aid program.

An Education IRA is a tax-exempt trust and must be designated as such at the time it is created. The trust instrument must provide that:

- no contribution will be accepted by the Education IRA after the beneficiary attains age 18.
- except in the case of rollover contributions, annual contributions to the Education IRA may not exceed \$500.
- all contributions must be made in cash.
- the trustee must be either a bank or other person that demonstrates an ability to properly administer the trust.
- no portion of the trust's assets will be invested in life insurance contracts.
- the assets of the trust will not be commingled with other property, except in a common trust or investment fund.
- upon the death of the beneficiary, any trust balance will be distributed to the beneficiary's estate within 30 days.

Any amount in an Education IRA may be rolled over into another Education IRA with the same beneficiary or for the benefit of a member of the original beneficiary's family. This provision allows any residual assets in an Education IRA, after the beneficiary finishes his or her education, to be transferred to another family member. A family member is defined to include ancestors, lineal descendants of the taxpayer, and the lineal descendants of the taxpayer's ancestors (e.g., uncles, aunts, nieces and nephews).

Federal law requires the trustee of the Education IRA to file information reports with the Secretary of the Treasury and the beneficiary. Federal law also imposes a penalty for failure to file such reports.

Any balance remaining in an Education IRA at the time the beneficiary becomes 30 years old must be distributed to the beneficiary or to the beneficiary's estate. The earnings are included in gross income and the 10% penalty is imposed.

State law conforms to the federal Education IRA except that a 2 ½ percent penalty applies in lieu of the federal 10% penalty. A copy of the required federal report is required to be filed with the FTB.

### THIS BILL

This bill would make the following modifications to the federal Education IRA for state purposes only:

1. Maximum permissible contributions to an Education IRA will be increased to the following amounts:
  - \$1,000 for taxable years beginning on or after January 1, 2001 and before January 1, 2002.
  - \$2,000 for taxable years beginning on or after January 1, 2002 and before January 1, 2003.
  - \$3,000 for taxable years beginning on or after January 1, 2003 and before January 1, 2004.
  - \$4,000 for taxable years beginning on or after January 1, 2004 and before January 1, 2005.
  - \$5,000 for taxable years beginning on or after January 1, 2005.
2. Qualified higher education expenses can include elementary and secondary education costs.
3. A separate Education IRA can be established for the contributions in excess of those allowed under federal law to prevent the disqualification of the federal Education IRA.

### IMPLEMENTATION CONSIDERATIONS

The bill would modify, for state purposes, the federal definition of qualifying higher education expenses to include costs for elementary and secondary education. A definition of "elementary and secondary education costs" would be helpful to prevent disputes with taxpayers and simplify the administration of the California Education IRA.

Since a California Education IRA would not be treated as an Education IRA for federal purposes (due to both the increased contribution limits and the expansion of the permitted educational expenses that may be paid from the account), the trustee would not be required to report to the Secretary of the Treasury or the beneficiary of the account under federal law. As a result, the FTB would be required to establish requirements for reports to the FTB and to beneficiaries with respect to contributions, distributions, and other matters regarding these accounts as the FTB may require. The time and manner and content for these reports must also be established. If regulations were required, the time frame to promulgate such reporting guidelines could hamper the establishment of California Education IRAs for the current taxable year, i.e. the taxable beginning January 1, 2001. A waiver of the rulemaking requirements of the Administrative Procedures Act would permit expedited promulgation of necessary guidance.

### **LEGISLATIVE HISTORY**

SB 1233 (Lockyer, Stats. 1997, Ch. 612) conformed California law to the federal Roth and Education IRA provisions.

### **OTHER STATES' INFORMATION**

**Minnesota** provides both an education credit and a deduction from gross income for qualifying education expenses for grades K-12.

**Michigan** provides a non-refundable credit for college tuition and fees paid by all students attending specifically approved colleges and universities.

**Illinois** provides a credit for education expenses paid by a parent or legal guardian of a student in grades K-12 at a public or nonpublic, elementary or secondary school.

**Massachusetts** allows a deduction for student loan interest and a deduction for college tuition paid to a qualifying two or four year college leading to an undergraduate or associate's degree, diploma, or certificate.

**New York** allows a deduction up to \$5,000 per year from taxable income for contributions to the New York College Savings Program for a designated beneficiary.

These states were reviewed because of the similarities between California income tax laws and their tax laws.

## **FISCAL IMPACT**

Once the implementation concerns are resolved, this bill would not significantly impact the department's programs.

## **ECONOMIC IMPACT**

This bill would result in revenue losses as shown in the following table:

Fiscal Year Cash Flow Impact* Enactment Assumed After 6/30/01 \$ Millions		
2001-2	2002-3	2003-4
-\$5	-\$13	-\$22

\*Note: This estimate assumes the enactment of companion federal legislation.

This analysis does not take into account any change in employment, personal income, or gross state product that may result from this bill becoming law.

This analysis assumes the passage of companion federal legislation. In the absence of such federal legislation, the benefits to most taxpayers from this program would be small relative to the costs of opening and operating separate accounts for California purposes. Therefore, the number of taxpayers participating and the revenue loss from this program would be substantially smaller than the above estimate.

The revenue loss from increases in educational IRA contribution limits is estimated by taking a percentage of the revenue loss estimate for a federal proposal to expand these limits (JCX-11-01). The estimate for the revenue loss from the extension of educational IRAs to K-12 students assumes that, when fully phased in, the number of program participants will be equal to approximately ½ of the

640,000 private elementary and secondary school students in California (California Statistical Abstract).

The estimate assumes, however, that the first accounts for elementary and secondary students will not be opened until the end of 2001, and that it will take about 3 years before normal participation levels are reached. The estimate assumes that assets placed in these IRAs earn a return of 8 percent per year and that the average marginal tax rate on these earnings is 7 percent.

## **POLICY CONCERNS**

This bill makes the state contribution limits more generous than the federal maximum contribution amount of \$500 and allows withdrawals for secondary and elementary schooling. Under the provisions of this bill, every Education IRA established under this bill's provisions would be ineligible for federal tax treatment as an Education IRA. For federal purposes, the California Education IRA would be treated like any other trust. Generally, trusts are treated as separately taxable entities. The fiduciary is required to file returns and pay tax on the income of the trust. Since the California Education IRA would be disqualified under federal law, the incentive for taxpayers to establish or contribute to a California Education IRA might be reduced by the current federal taxation of the trust.

The bill modifies existing law "in construction and as otherwise necessary to comport to" provisions of existing law, as amended by the bill ". . . if deemed necessary by a trustee . . .[.]" This authority to modify existing law may be considered an unconstitutional delegation of legislative authority.

## **LEGISLATIVE STAFF CONTACT**

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